

Moscow Financial Weekly

For the Week Ending September 7, 2001 (Plus Sept 11th)

Treasury Attache's office, US Embassy Moscow

Highlights This Week

- US attacks cause temporary currency instability
- Banking reform starts to take shape
- **Weekly Focus: Retail Banking**

Key Economic Indicators

Indicators	Level	% chg 1 week	% chg since Jan. 1
Ruble/\$ (MICEX) UTS	29,4320	0.09	4.50
Monetary Base*	R621.6 bln	-1.13	28.78
CPI	NA	N/A	13.2
International Reserves*	\$37.5 bln	1.33	30.74
RTS Index (end of week)	207.21	0.88	45.63
Refinancing rate	25	0	0

*For week prior

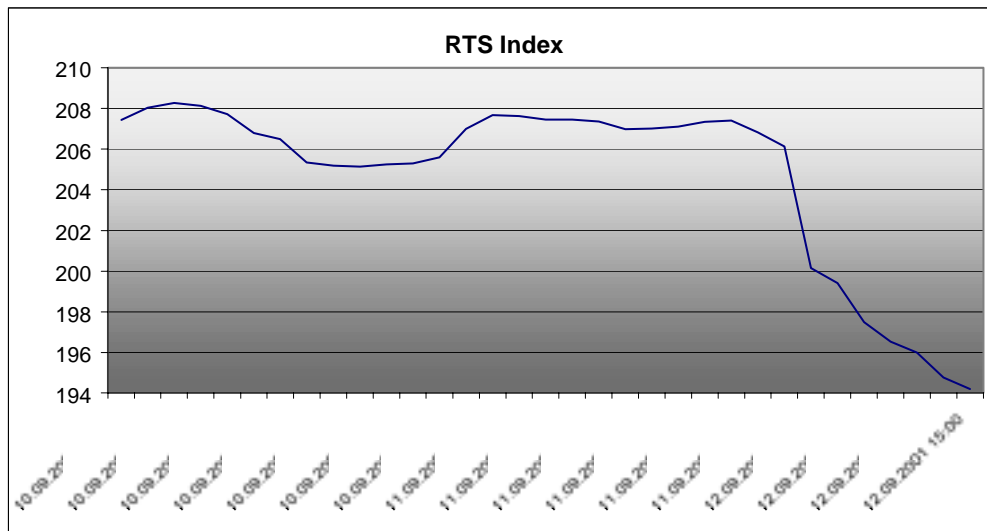
Aftermath of U.S. Attacks

Currency: By the time the news hit Tuesday evening the MICEX trading session had already closed. With no market benchmark, some Russians rushed in panic to exchange points to sell their cash. Exchange point operators were happy to oblige. Reportedly, at night in downtown Moscow exchange booths offered R15-R17 per dollar and some individuals were willing to sell at that rate. The sell rate, meanwhile, remained unchanged, so the spread increased dramatically. By 9 a.m. things had calmed and the prevailing buy rate at Moscow exchange points was R26-R27 per dollar, yet many booths refused to buy dollars at all, claiming they had run out of rubles.

Later in the morning the Moscow Main Directorate of the CBR started raiding banks and exchange points "in order to prevent abuses in the cash currency market". Sanctions were to be applied to banks whose spreads exceeded 15%. President Putin met with Prime Minister Kasyanov and CBR Chairman Geraschenko in the morning to discuss the situation. After the meeting, Geraschenko and Kasyanov made statements, assuring public that the rate would stabilize "within a day or two". Kasyanov also stressed that all dollar settlements through U.S. banks in the morning "were completed in full" and settlements between Russian banks were also carried out in a regular way. Geraschenko warned Russians against selling dollars "at any rate". Kasyanov added there is no reason to expect any dramatic events on the markets, because "the fundamentals of the American economy are still very strong". Bank traders, however, say that half of MICEX trading session participants did not receive the currency that was due to them in the MICEX clearing house, which correspondingly cut in half the supply of dollars in the UTS session. On the other side, demand for dollars remained at the same level as the day before. At least 50% of the demand traders attribute to the CBR.

The dollar closed at R29.4455 in the UTS, just marginally firmer than on Tuesday. The "tod" dollar fixed at R29.4620 and the "tom" at R29.4737, both slightly weaker than before. Interestingly, bankers say that price of cash dollars may surge later this week. Because there are no flights coming from the U.S., banks can import currency only from Europe. European banks, reportedly, have already increased commissions 10 times since yesterday. According to banking sources, the stock of dollars in Moscow is enough for a day or two, after which they expect a shortage of cash.

Stock market: News about the tragedy in the US reached the Russian market at the end of the trading session. The market went slightly down, but then stabilized on news of increasing "spot" oil prices. Sharply lower world indices had a negative effect on the market next day (Wednesday). The market opened 2.9% lower compared to the previous day. Most of the blue chips lost 3-5% during the first hour of trading. The market gradually fell through 3pm and then began to rise very slowly toward the end of the day. At close, index stood at 194.97, 2.59% lower than the opening price and 5.41% down on the previous day close. Prices of oil shares were the most stable during the session.



Economic Developments (week prior)

The federal **budget** ran a deficit of R11 billion in August, reflecting a major interest payment to the Paris Club and a jump in spending for the army. Revenues totaled R133.25 billion (105.9% of target), while expenditures were R144.28 billion. Meanwhile, the federal budget surplus in the first 8 months of 2001 was R85 billion or 1.5% of GDP. Expenditures during that time were R895 billion (75% of the annual target) and revenues R980.1 billion (82% of the annual target and 110% of the Jan.-Sept. target).

Moody's increased its rating of Russian Eurobonds from B2 to B3 and simultaneously changed all ratings forecast from "stable" to "positive". According to the agency, economic reforms have lead to the federal budget surplus and increase in the international reserves, which increased the capacity of the country to service its debt.

The GOR announced details of its plan for reforming **Gazprom share trading** (the so-called ring-fence), though unfortunately for foreign investors, not the all the crucial ones. Initially shares will be allowed to trade on a number of additional exchanges, including MICEX and the GOR will liberalize rules on which depositories are allowed to hold Gazprom shares. At some later date the cap on foreign ownership should be raised to 20% from 14% and, according to Gazprom officials, local shares would be made freely convertible to ADRs. Left undetermined was how and by whom share sales to foreigners would be regulated and the timing of all these changes. If substantial liberalization takes place, it would constitute a good first step in bringing down the “ring fence” and could be enough to gain the interest of global institutional investors who have generally shied away from Gazprom ADRs.

Banking sector

Discussions on **bank reform** seem to be gathering momentum, with the September 26th Cabinet meeting on the topic looking increasingly like a watershed in finalizing a consensus between key players. These are CBR, the government, Duma leaders, the Union of Industrialists and Entrepreneurs (RUIE, represented by Mr. Mamut) and the Banking Association (if they really count). If, and banking reform has had many false dawns, this plan is agreed, Russia could have significant reforms passed this winter or spring and in place by the beginning of 2003.

The first sign of movement came at last week’s conference on financial services in Sochi where Tatiana Paramonova, CBR First Deputy Chairman, conceded two major points of the Mamut proposal: 1) that higher minimum capital standards are desirable and 2) that there could be different classes of banking licenses for different categories of banks. “We should not allow too much time to banks which have too low capital. If the capital falls too low, we probably should consider replacing the banking license with a different kind of license,” she said. Paramonova also said that the CBR and the RUIE had “basically no significant disagreements regarding the objectives and principles of the reform [though] there may be different views on the means of banking system consolidation and the amount of capital that RUIE suggested as the threshold for presence in the market.” (Mamut’s original proposal set \$100 million as the minimum capital level to be granted a general license.)

While there is a big difference between agreeing in principal and in fact, reports from a subsequent CBR meeting on bank restructuring on Sept 11th and comments by Mamut’s RUIE cohort Peter Aven indicate that deals are being made. Aven described a possible consensus on a plan that would require minimum capital requirements in the \$10-30 range and some from of IAS accounting in order to get a general license. Banks with a general license would be allowed to engage in all banking activities including taking individual deposits and correspondent banking, and would be eligible for deposit insurance. Banks that did not meet these standards would not be eligible for any of these, though they could continue to operate. While this may represent RUIE’s current preferred outcome rather than a consensus, it does show a willingness to compromise, especially on the controversial minimum capital requirement proposal. The proposal also has the benefit of having a deposit insurance scheme that distinguishes between banks that meet higher standards and those that don’t. Such a scheme would have fewer moral

hazard risks than a universal system and would create incentives for better behavior. A working group representing CBR, the RUEI and the government will reportedly meet next week to continue to try to hammer out a consensus before the cabinet meeting.

While the discussion over how **deposit insurance** will fit into a broader bank reform plan continues, a GOR/CBR draft law seems to be nearly ready. Georgy Luntovsky, CBR Deputy Chairman, said he hopes that the GOR will bring it to the Duma in late September/early October and that it can be passed by the end of this year. (The latter does not seem likely because, according to Duma sources, first reading of the bill is scheduled only for December 20). He noted a number of details of the draft:

- Deposits will be guaranteed not only by the Federal Reserve Corporation, but also by the Fund for Private Deposit Guarantees;
- All credit organizations will have to pay, on a monthly basis, 0.6% of the deposits they hold to the Fund, while the Corporation will manage assets of the Fund and when necessary reimburse the depositors of banks that failed;
- Money collected by the Fund will be invested only in government securities, possibly including foreign securities.
- Sberbank will participate in the system from the very beginning, but at the first stage it will accumulate its share of reserves in an escrow account at the CBR. The CBR will manage these funds until the moment it quits the capital of Sberbank. After that Sberbank will participate in the deposit guarantees system on equal terms with all others.

Banks with government participation should be reorganized into specialized agencies or non-banking credit institutions, Alexander Shokhin, Head of State Duma's Banking Committee told the Sochi conference. He stressed that this should be done only to banks with GOR, but not the CBR participation. He also criticized the plan to force Vneshtorgbank (VTB) to purchasing the "roszagranbanks" (CBR's foreign daughters). If VTB needs them as a universal bank, let it buy them, otherwise shares of foreign banks currently owned by the CBR should be sold in an open tender.

This week Minfin appealed to CBR that it allow banks and residents of the RF to freely carry out transactions with Russia's eurobonds. Currently, it is illegal for a resident to buy a **eurobond** from a non-resident since this is a capital transaction requiring a permission from the CBR. If two residents trade eurobonds, it is a violation as well, because the transaction is cleared in foreign currency. Currently only certain licensed banks are allowed to carry out transactions with eurobonds.

The draft 2002 budget provides that R15 billion worth of **GOR debt to the CBR** be converted to market securities, Mikhail Zadornov, Chairman of State Duma's Subcommittee on Monetary Policy told a press conference. Total outstanding debt to the CBR is R250 billion. This year R20 billion was converted into other instruments. While small, the conversion of this debt to market instruments will modestly help CBR in sterilizing future dollar inflows.

More on sterilization instruments: on September 6, for the first time since December 1999, CBR placed its new **"beaver" bond** (OBR) issue. It offered two kinds of bonds: 2-week and 3-week with a volume of R4 billion. There were R434 million worth of 3-week

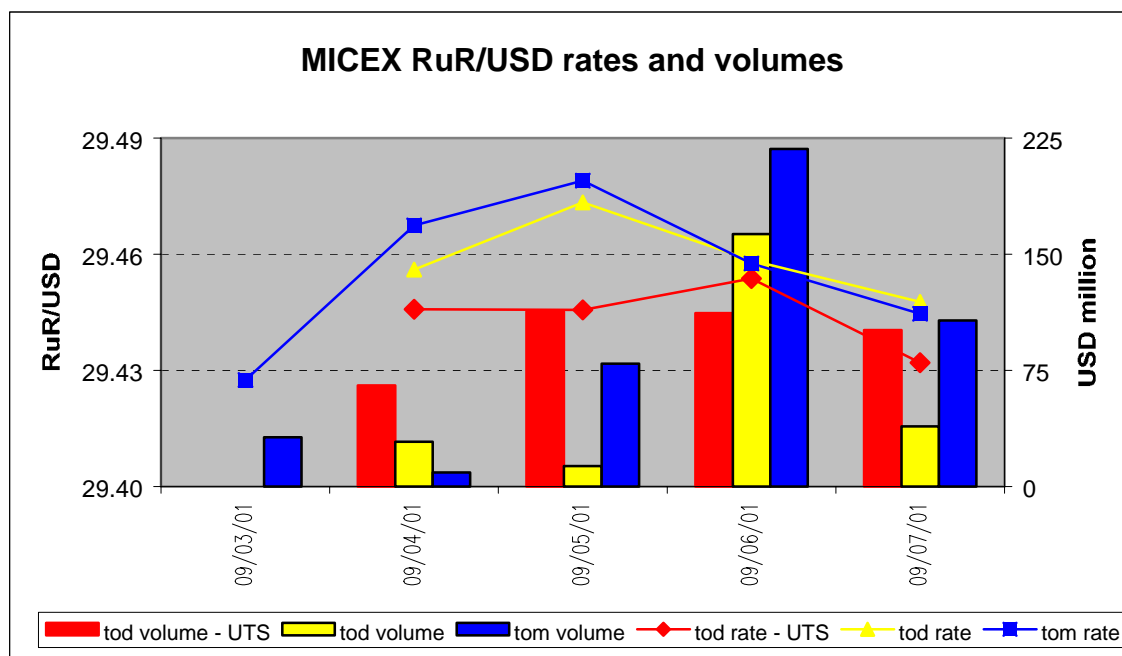
bonds placed at 10.32% p.a. and R419 million worth of 2-week bonds placed at 9.68% p.a. For both securities the CBR paid a premium against its deposits with similar terms (10% and 9%, respectively) and volumes were just enough for the auction to be valid. Nevertheless, the CBR considers the auction to be relatively successful, given the market conditions that week (OFZ placements, new CBR's term deposits and especially the advancing currency market).

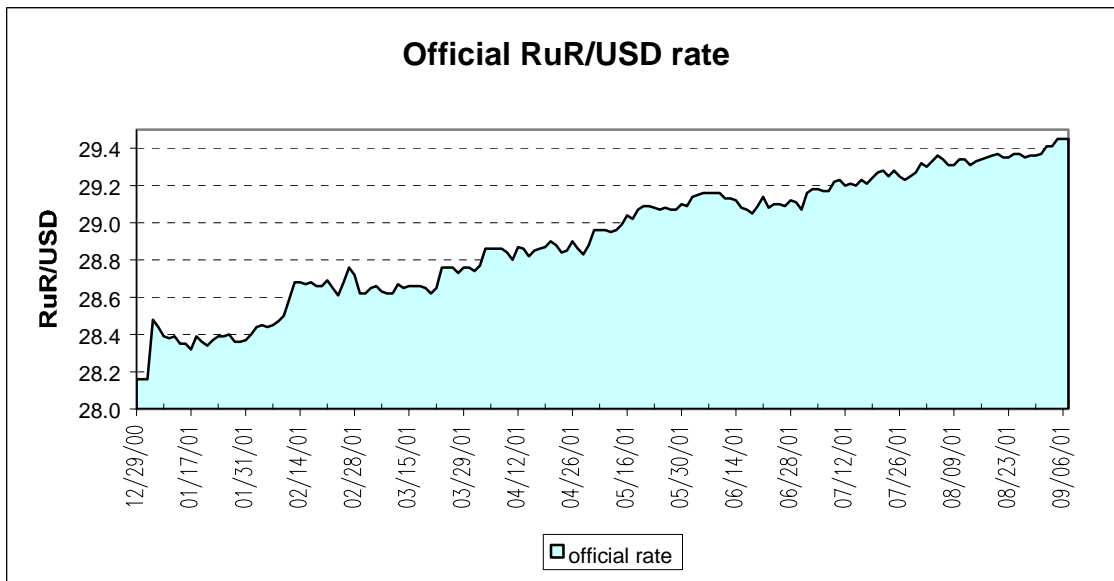
Financial markets

Forex Market

The ruble steadily weakened against the dollar on abundant ruble liquidity all through Thursday, when the CBR intervened in the morning trading after the rate in the interbank market reached R29.49. The CBR started selling dollars at the market rate, then reduced it to R29.47 and finally to R29.4550. As a result trade volume in MICEX afternoon trading surged, banks overbought dollars and on Friday the ruble regained some of its previous losses.

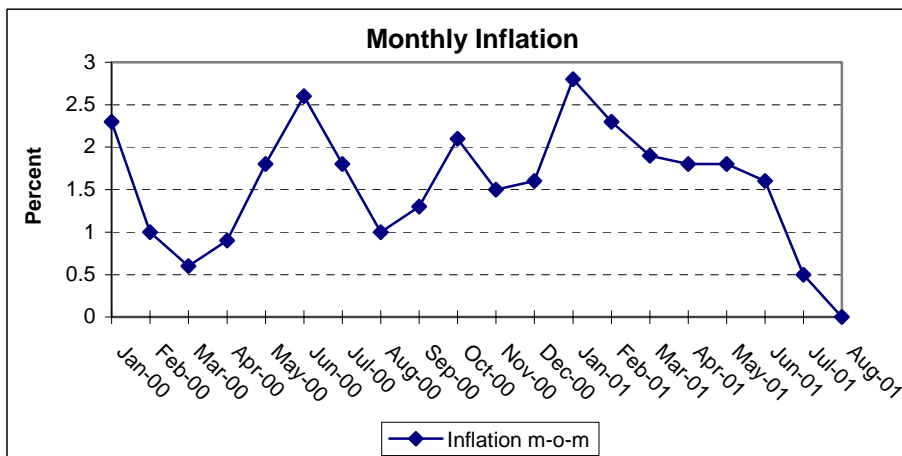
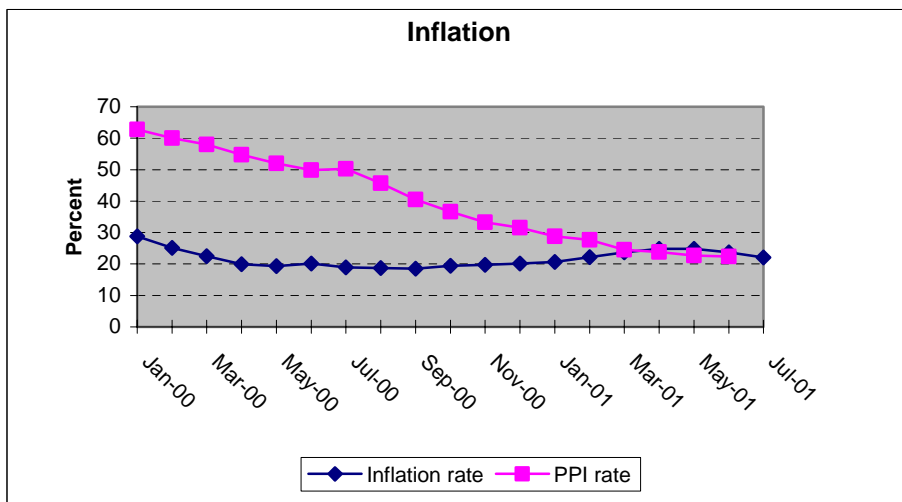
For the week the ruble weakened 0.09%, closing in the UTS on Friday at 29.4320/\$. MICEX weekly trade volumes were \$391.57 million, \$244.09 million and \$445.37 million for the morning (UTS), afternoon "tod" and "tom" sessions, respectively.





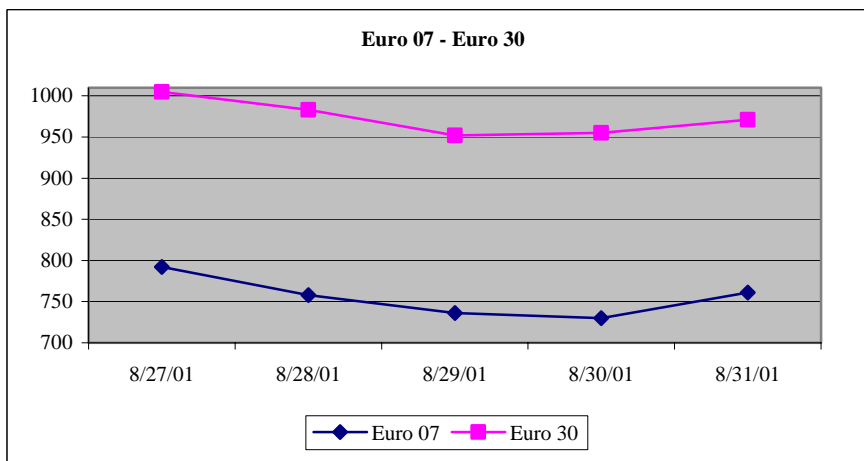
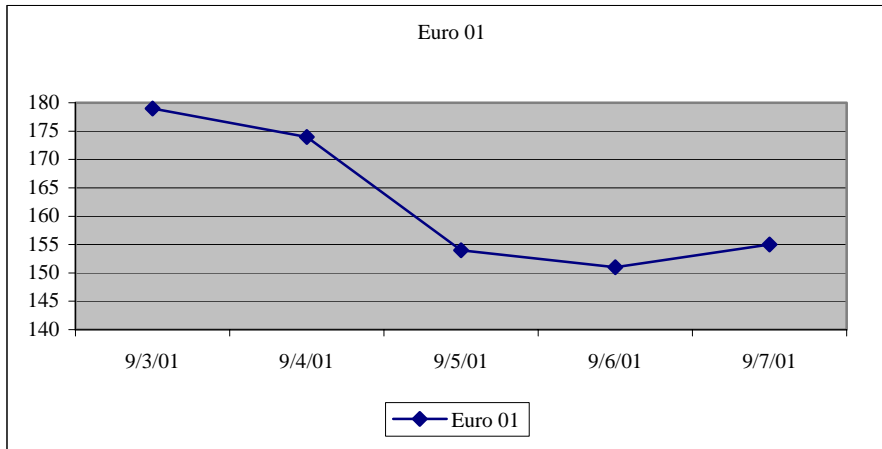
Prices

No September data is available. Based on seasonality, we would expect inflation to begin to rise from its zero rate in August.



Eurobonds

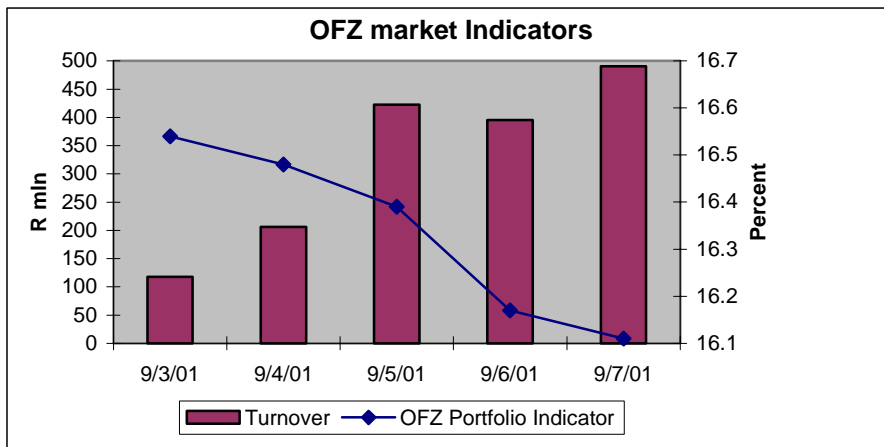
Price growth in the Russian segment of the eurobond market continued last week. Good macroeconomic news - production growth as well as continued growth of international reserves supported the upward trend. News about Russia's rating upgrade pushed the market even further - yields on practically all issues except Euro-30 went down below 13% p.a.



Interest/Bond Market

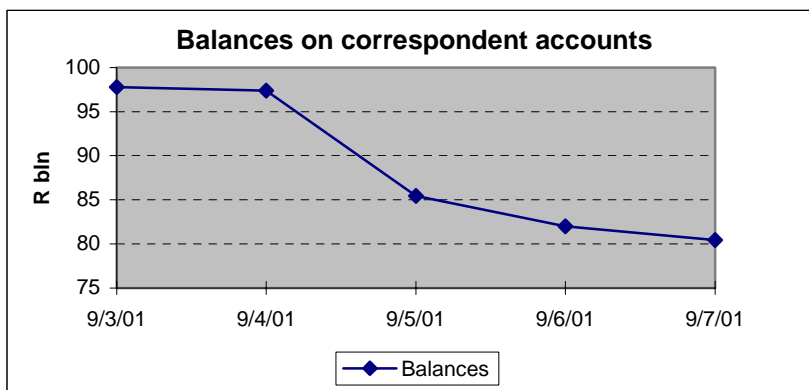
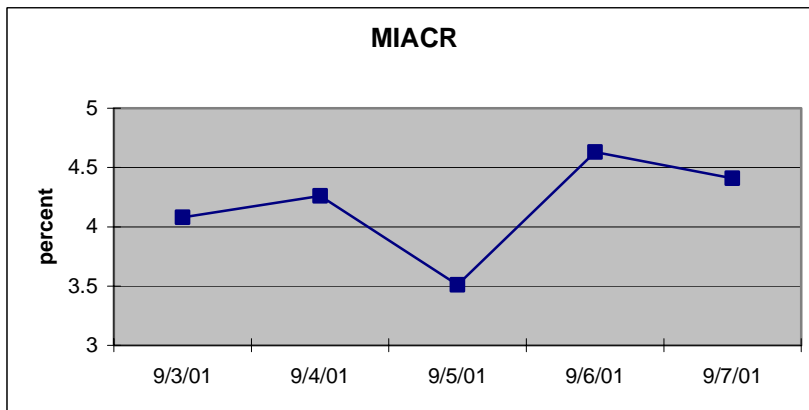
Bonds/Bills

Yields on the secondary OFZ/GKO market were down further last week. Activity was low due to the low yields (negative real rates) and the major player on the market was Sberbank as usual.



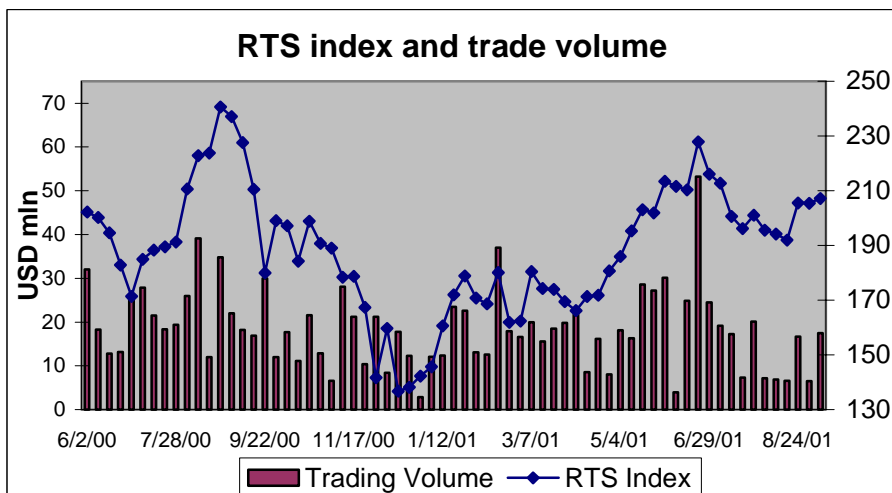
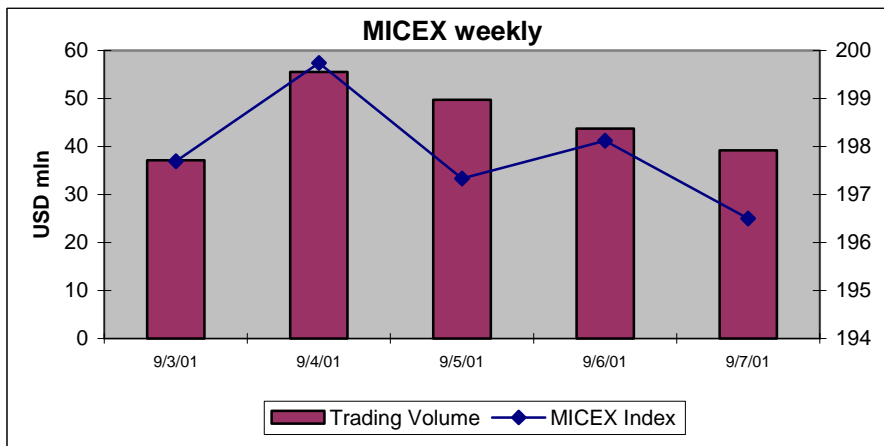
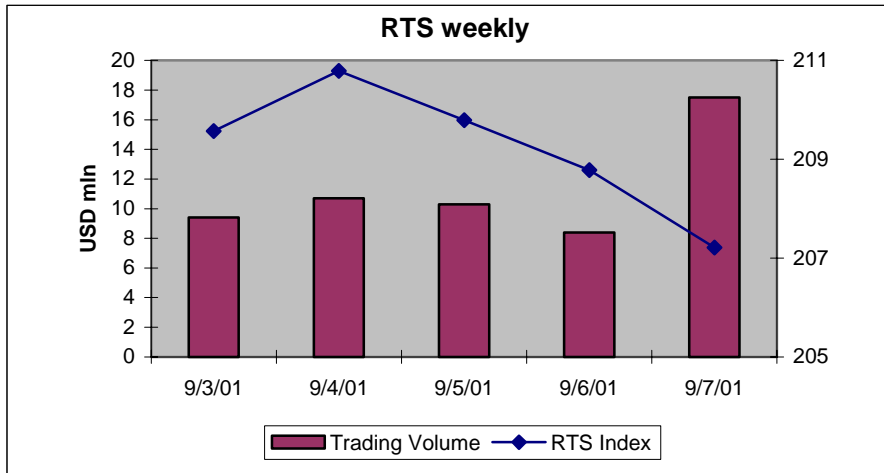
Overnight rates

Short-term interbank ruble loan rates were kept down by the increased ruble liquidity in the banking system. Balances on banks' correspondent accounts at the CBR stood in the upper 90's at the beginning of the week, dropping through the rest of the week. During the week balances were down by R17.3 billion and reached R80.5 billion by Friday.



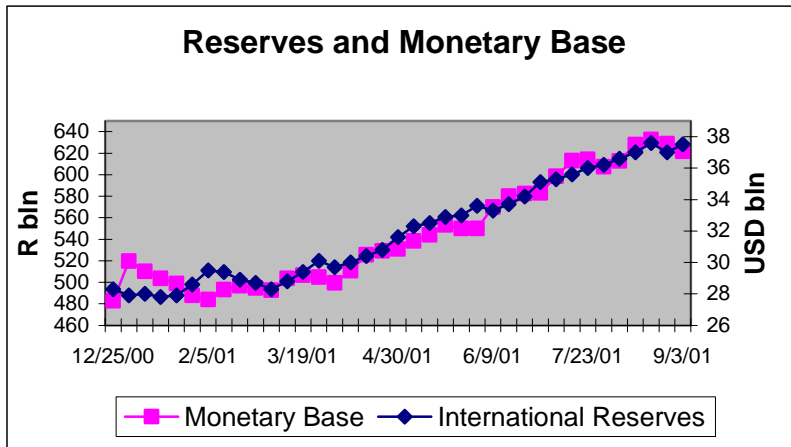
Stock Market

The stock market started the week up and rose further on Monday, but then slid throughout the rest week. Trade activity was lower than average with average daily trade volumes of \$11.3 million. Despite negative news from abroad, the Russian stock market seems to be in a good shape. Strong world oil prices is the major supporting factor. Last week's leaders were oil stock again - Surgut, LUKoil and YUKOS. The market finished the week up by 0.88% in dollar terms.



International Reserves and Monetary Base

International reserves of the Finance Ministry and Central Bank nearly recovered after the previous week's drop (due to scheduled debt payments), up by \$500 million to \$37.5 billion. Since the beginning of this year the reserves have grown by \$9.2 billion. The monetary base decreased again last week by 1.13% or R7.1 billion and totaled R621.6 billion.



Retail Banking: Chipping away at Sberbank

Any discussion of retail banking (taking household deposits and lending to individuals and small business) in Russia should start with a few basic facts:

On the liabilities side:

- Sberbank 74.3% of personal deposits and 80% of ruble deposits.
- Sberbank has over 20,000 branches and service points; the rest of the banking system (with 1300 banks) has 2204 branches.
- Total deposits in Russia (dollar and ruble) as a % of GDP are 8.8% of GDP vs 92% in Germany and 52% in the US (which has much more developed capital markets).
- An estimated \$30 billion are thought to be held as mattress money vs. about \$17 billion in household deposits.

On the asset side:

- Consumer loans and credit cards are almost non-existent.
- A mortgage market is equally embryonic with a total of less than \$50M in mortgage lending to date, mostly in dollars.
- Small business lending is very small relative to GDP.

These facts illustrate what is clear to most: 1) Sberbank's huge branch network and explicit government deposit guarantee give it a major advantage that cannot be replicated by competitors; 2) even with a government guarantee, Russians do not trust banks with much of their money (though this may be changing slightly); and 3) banks don't trust retail customers enough to lend to them which means the products that make up most of banks' retail business in the West don't really exist in Russia.

All of this does not make retail banking in Russia seems very attractive. And yet a number of Russian commercial banks, including foreign banks, are building retail banking businesses and other may be ready to jump in. This week we look at the opportunities and obstacles to retail banking, how players are attacking different niches, and what may change to improve the environment for retail banking in Russia.

The liabilities side – building trust on an uneven playing field

The lack of long-term liabilities in the Russian banking system is a fundamental problem for Russia. Without long-term funding, Russian commercial banks cannot make the kinds of long-term loans for equipment or infrastructure without exposing themselves to dangerous asset/liability mismatch. There are essentially three ways to raise long-term liabilities – issue securities (e.g. eurobonds), receive syndicated loans from other (in Russia's case foreign) banks, and attract a corpus of depositors who in aggregate maintain a consistent level of funds on account. Prior to the 1998 crisis the first two were the primary long-term funding sources for major Russian commercial banks. After the crisis only the latter remained as a viable prospect. This has increased the draw of retail banking.

But attracting deposits is easier said than done. Many Russian savers have lost their savings in the banking system three times in the last ten years either through expropriation, hyper-inflation, or default. Not surprisingly they are wary. Prior to the 1998, commercial banks had made some headway in taking retail deposits from

Sberbank, despite its government guarantee, with the share of commercial bank deposits climbing to 32%. But when the crisis hit, state banks were bailed out while commercial banks were left to their own devices and many, though not all, ended up failing to make their depositors whole. Even Russian banks that did not default to their depositors were tarred with the crisis. The process of rebuilding trust has had to start from scratch with Sberbank even more entrenched as the only safe harbor (to the extent such a thing exists in Russia's banking system).

Competing for deposits with Sberbank involves more than just building trust. Commercial banks claim that they face higher regulatory, physical security and than does Sberbank (though CBR denies this). What's more they claim that Sberbank does not actually comply with the requirement to place prudential reserve (7% of deposits for dollar accounts, 10% for rubles) at CBR. It also is simply impossible for commercial banks to acquire a branch network to compete with Sberbank's, given that it takes roughly a year to work the regulatory process of starting a new branch and costs \$500,000 to \$1M per. Only if Sberbank is forced to divest of some of its branches (a distant prospect) will there be the prospect of really creating competitive branch networks. Finally, Sberbank's special status makes it very difficult to compete for ruble deposits with higher deposit rates. Sberbank rates on ruble deposits vary from 2% for demand deposits to 18.5% for 2 yr CDs. With current inflation around 20% these are negative in real terms. These low rates should give commercial banks a chance compete on price, assuming they can overcome the trust issue. Unfortunately, on the other side of the balance sheet, Sberbank also distorts the market by providing low loan rates to the most desirable creditors. This tends to keep margins in the 3-4% range and reduces the price competition for retail ruble deposits. Competition is greater for dollar deposits, with Sberbank having only about 50% of the market, but loan margins are still relatively modest.

A few chinks in the armor

So how do banks do it? Basically it comes down to service and attacking niches. Sberbank does its competitors a favor by providing notoriously bad service. For those who do little more than collect their paycheck through the bank or who live where Sberbank is the only option, this is not a major issue. But for higher income depositors who want plastic (debit) cards, bank transfers and more, service can be a wedge to pry customers away. Happily for the commercial banks, these are exactly the customers that they want to target. Sberbank's monopoly on key niches is also not absolute. For example in the area of pensions, Petrovsky Bank in St Petersburg has quietly secured the business of handling state pension payments which in most of the rest of the country is held by Sberbank. Last year MDM Bank bought Petrovsky, in large part in order to get a foothold in this niche. While this is not the most lucrative market for services, it does provide a very predictable float that can support longer-term liabilities. MDM also is looking to challenge the pervasive Sberbank branch network by providing banking services through Russia's pervasive but somewhat antiquated postal system.

Other banks such as Alfa are taking a more straightforward approach. Alfa currently has the largest commercial branch network with over 70 branches and are building what they say will be a network of 300-400 branches over the next five years. So far most of their

growth has been done with GOR assistance: ARCO provided Alfa with a credit of R2 billion to build around 60 branches in under-served regions. For the future Alfa is not targeting a specific niche, but rather families with incomes of 2 times the average income or above. This puts them in direct competition for a core piece of Sberbank's business.

Whether these Russian commercial banks can achieve their goals probably depends on future efforts to level the playing field. In the meantime Alfa has about 1.3% of deposits nationally, about the same as Gasprombank (who has a parent with a large payroll), and a little more than Vneshtorgbank, Bank of Moscow and Raiffeisen, the latter being the only foreign bank that has made a significant push into retail banking.

Foreign banks – a question of risk.

While there has been a lot of talk about foreign banks entering the retail market, the three main foreign entrants, Raiffeisen, ABN-Amro and Bank Austria, cumulatively have less than 1% of deposits, nearly all of it in foreign currency. These banks were generally dragged into the retail market after the 1998 crisis as they tried to provide payroll services for their corporate clients. Expansion has meant adding high-income depositors, often expats, who are willing to pay higher service fees in exchange for the security of a foreign bank. While they have seen some growth, foreign banks generally have shied away from a broader retail strategy. Profitability is one reason – the payback for the large investment it takes to build a retail network will come far in the future and only if the competitive situation and profitability improve. Perhaps a more important reason, however, is risk. Foreign banks are subject to their home country's regulators who tend to scrutinize Russian operations closely for problems such as money laundering. (It may not be a coincidence that Austrian banks have been the first into the markets, given Austria's reputation for being relatively lax on money laundering.) On top of this, current Russian law forbids banks from closing a depositor's account if they suspect illegal transactions. This means that due diligence on new accounts has to be foolproof. The foreign banks in the market use a combination of price discrimination and document requirements to select those with which they want to do business. Other foreign banks have just stayed out.

Raiffeisen has been the most aggressive foreign bank in the market but even it has 99% of deposits in foreign currency and serves a relatively high-end market. By its own admission, its strategy will keep it as a niche player rather than a true competitor to Russian banks. Bank Austria is in the process of merging with a Russian bank, International Moscow Bank, which presents other possibilities for combining the strengths of foreign and domestic players. The prospect of foreign banks assuming the dominant role they have in other transition countries looks rather dim. Still by bringing new technologies and products into the market, particularly consumer lending, they can play an important role in the market's development which remaining niche players.

Keys to improving retail's prospects

The seeming renewed interest in banking reform at CBR and in the government over the past month could signal that changes may move forward in the coming year. For retail banking, the most significant reform would be a new deposit insurance scheme. The

primary goal of a scheme would be to close the competitive gap between Sberbank and the rest of the market but eventually it also could help draw mattress money into the system. How well it works depends on the credibility of the scheme. A scheme that requires banks to meet standards for capital, transparency and management in order to qualify for insurance would clearly be more credible than a universal scheme. This is critical since the government for fiscal reasons seems disinclined to provide a blanket guarantee as it does for Sberbank. Only if people see the guarantee fund as able to meet likely liabilities will they abandon Sberbank. The other question is the level of funds that are to be covered. A low ceiling (\$2000 has been mentioned) seems likely even though it would not bring significant new funds into the system. However, if broader reform leads to a more consolidated and better-supervised system, the ceiling eventually could be raised.

Other reforms that would help to develop a competitive retail market include the land code, rules on collateral, and developing a credit rating system. Without these changes to help build small business, mortgage and consumer lending markets, the asset side of retail banking is likely to remain moribund.

The Future

Trust takes a long time to build. One view is that by the time the banking sector really begins to function, capital market development, perhaps spurred by pension reform, will have taken up much of the intermediation function. Another says that it will be taken over by large conglomerate who do their own internal intermediation. Unfortunately international experience provides few examples of the former; development of bank intermediation has always preceded that of capital markets. The latter, while not improbable, essentially leaves much of the country's household savings untapped. Commercial retail banks still are the only institutions that can efficiently lend to small business, the greatest source of jobs and growth for the economy. So Russia has little choice but to try to build a base that depositors will trust, however long it takes. What is most important is to do it right this time. Another crisis and a failed deposit insurance system could be the final blow, calcifying a state system and permanently denying Russia the benefit of its citizens' savings. Hopefully the third (or is it the fourth?) time's the charm.

Questions or Comments?

Please send your questions or comments on this Weekly to ["ustreasu@online.ru"](mailto:ustreasu@online.ru).

EXPLANATORY NOTES

1. **EXCHANGE RATES:** SELT - "System of Electronic Lot (currency) trading" -- a computer based OTC-style trading system organized by the Moscow Interbank Currency Exchange (MICEX). "\$-tod" price is the price of the dollar with same day delivery. "\$-tom" is the price of the dollar with delivery on the next day. Minimum lot size for each

of the dollar instruments is \$100,000. Average price is quoted as the weighted average of all actual deals entered into the system by various banks.

2. INTEREST RATES: Moscow InterBank Actual Credit Rate is calculated as the average-weighted rate on the volume of actual transactions in interbank loans by commercial banks.

3. STOCK INDICES: The RTS index is the only official indicator of the Russian Trading System. It is calculated every 30 minutes of the RTS trade session, starting at 12:00. It comprises 60 shares of 35 leading companies. These shares are included in so-called Category "A" listings. The index indicates over-the-counter stock prices. The index represents the ratio of the total market capitalization of the shares of the companies selected for the index to the total market capitalization of the same shares as of the initial date multiplied by the index value as of the initial date (31 December 1997) using a base of 100 beginning September 1, 1995. The ruble-adjusted index is a derivative of the main dollar index, using the same base. The MICEX index is calculated by the stock section of the Moscow Interbank Currency Exchange and is based on the price fluctuations of 17 shares of the MICEX's first and second listings.

4. INTERNATIONAL RESERVES OF THE RUSSIAN FEDERATION represent the amount of reserve assets of the Bank of Russia and Finance Ministry. Those reserve assets are comprised of monetary gold, special drawing rights, the reserve position in the IMF and other liquid foreign assets. The latter include short-term deposits in non-resident and resident banks, balances in current accounts, foreign government securities, repo agreements with these securities made with non-residents, and other liquid assets (accrued interest on these assets is not included). Monetary gold is evaluated at a floating rate, revised periodically, but not always reported immediately. Foreign currency assets are converted into U.S. dollars on the basis of the cross rates of foreign currencies to the dollar, calculated using the official rates of the ruble to these foreign currencies, as set by the CBR.

5. MONETARY BASE (M1) is comprised of cash and reserves of commercial banks on deposit in the CBR. It is the basic part of the money supply (M2).

6. LOMBARD CREDITS, distributed through auctions, are aimed to provide liquidity to the banking sector. These credits are extended to banks on the basis of collateral.